

**STATE OF ALABAMA
DEPARTMENT OF INSURANCE
MONTGOMERY, ALABAMA**

REPORT OF EXAMINATION OF

NATIONAL SECURITY INSURANCE COMPANY

ELBA, ALABAMA

AS OF DECEMBER 31, 2004

**PARTICIPATION:
SOUTHEASTERN ZONE, NAIC
ALABAMA**

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**STATE OF ALABAMA
COUNTY OF COFFEE**

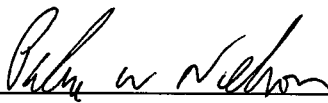
I, Palmer W. Nelson, being first duly sworn, upon his oath deposes and says:

That he is an examiner appointed by the Commissioner of Insurance for the State of Alabama;

That an examination was made of the affairs and financial condition of National Security Insurance Company for the period of January 1, 2001, through December 31, 2004;

That the following 41 pages constitute the report thereon to the Commissioner of Insurance of the State of Alabama;

And that the statements, exhibits and data therein contained are true and correct to the best of his knowledge and belief.

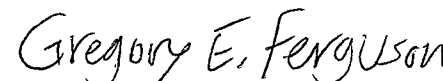


Palmer W. Nelson, CFE

Subscribed and sworn to before the undersigned authority this 20th day of April, 2006.



(Signature of Notary Public)


_____, Notary Public
(Print Name)

in and for the State of Alabama.

My commission expires 2/28/09.

MY COMMISSION EXPIRES 02-28-09



BOB RILEY
GOVERNOR

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
201 MONROE STREET, SUITE 1700
POST OFFICE BOX 303351
MONTGOMERY, ALABAMA 36130-3351
TELEPHONE: (334) 269-3550
FACSIMILE: (334) 241-4192
INTERNET: www.aldoi.gov

Elba, Alabama

April 20, 2006

WALTER A. BELL
COMMISSIONER
ASSISTANT COMMISSIONER
RAGAN INGRAM
DEPUTY COMMISSIONERS
D. DAVID PARSONS
CHIEF EXAMINER
RICHARD L. FORD
STATE FIRE MARSHAL
ED PAULK
GENERAL COUNSEL
RALPH REYN NORMAN
RECEIVER
DENISE B. AZAR
LICENSING MANAGER
JIMMY W. GUNN

Honorable Mike Geeslin
Chairman, Examination Oversight Committee
Insurance Commissioner
Texas Department of Insurance
333 Guadalupe Street
Austin, Texas 78701

Honorable Director Linda Hall
Secretary, Western Zone
Alaska Division of Insurance
550 West Seventh Avenue, Suite 1560
Anchorage, Alaska 99501-3567

Honorable Walter A. Bell, Commissioner
Secretary, Southeastern Zone
Alabama Department of Insurance
Post Office Box 303351
Montgomery, Alabama 36130-3351

Dear Director and Commissioners:

Pursuant to your instructions and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, an examination has been made of the affairs and condition of

National Security Insurance Company
Elba, Alabama

as of December 31, 2004, at its home office located at 661 East Davis Street, Elba, Alabama 36323. The report of examination appears herewith.

Where the term "Company" appears herein without qualification, it will be understood to indicate National Security Insurance Company.

SCOPE OF EXAMINATION

The Company was last examined for the five year period ended December 31, 2000, by examiners representing the Alabama Department of Insurance. The current examination covers the intervening period from the date of the last examination through December 31, 2004, and was conducted by Alabama Department of Insurance examiners. When deemed appropriate, transactions subsequent to 2004 were reviewed. The examination was made in accordance with the statutory requirements of the Alabama Insurance Code and the Alabama Insurance Department's regulations and bulletins; in accordance with the applicable guidelines and procedures promulgated by the NAIC; and in accordance with generally accepted examination standards and practices in connection with the verification of assets and determination of liabilities.

The examination included an inspection of corporate records, test checks of recorded income and disbursement items for selected periods and a general review of records and files pertaining to operations, administrative practices and compliance with statutes and regulations. Assets were verified and valued and all known liabilities were established or estimated as of December 31, 2004, as shown in the Financial Statements contained herein. However, the discussion of specific assets and liabilities in this report is confined to those items where a change was made by the examiners, or which indicated violation of the Alabama Insurance Code and the Insurance Department's rules and regulations or other insurance laws or rules, or which are deemed by the examiners to require comments or recommendations.

Company office copies of the filed Annual Statements for the years 2001 through 2004 were compared with or reconciled to account balances with respect to ledger items.

The market conduct review consisted of a review of the Company's plan of operation, territory, policy forms and underwriting practices, advertising and marketing, claims, policyholder complaints, agents' licensing practices and compliance with privacy standards.

The Company's accounts were examined by Barfield, Murphy, Shank & Smith, PC, certified public accountants (CPAs), for each of the four years under examination. The examiners reviewed the CPAs audit reports and certain CPAs work papers. The examiners elected to not use any of the work performed by the independent auditor. Further discussion of the work

performed by the CPAs is included in this report under the caption "ACCOUNTS AND RECORDS."

A signed certificate of representation was obtained during the course of the examination. In this certificate, management attested to having valid title to all assets and to the nonexistence of unrecorded liabilities as of December 31, 2004.

ORGANIZATION AND HISTORY

The Company was incorporated February 5, 1947, as a mutual aid company in Coffee County, Alabama. It commenced business with paid up capital of \$25,000 divided into 250 shares of \$100 par value common stock and \$7,500 paid in surplus.

In 1955, the authorized capital stock was increased to 500,000 common shares, with a one-dollar par value, and the Company was converted to a legal reserve life insurance company. The Company merged with two Birmingham, Alabama based insurance companies, Alabama Life and Casualty Company in 1959, and Mercantile Life Insurance Company in 1961. The Company survived the mergers, and its subsequent capital stock was 1,200,000 common shares, with a par value of one dollar per share.

In 1987, Mutual Savings Life Insurance Company of Decatur, Alabama, acquired 22.2% of the Company's common stock, in an attempt to take control of the Company. Acquisition of control by Mutual Savings was disapproved by the Alabama Department of Insurance on March 2, 1988, pursuant to a formal hearing. Mutual Savings appealed the Department's ruling, but during the litigation that followed, control of Mutual Savings changed hands. A settlement agreement was reached with the new owners of Mutual Savings, and in accordance with said agreement, the Company purchased the 226,243 shares of its stock held by Mutual Savings.

In 1988, the authorized capital stock of the Company was increased to 10,000,000 common shares, with a par value of one dollar per share. Also, 10,000,000 shares of preferred stock, with a par value of one dollar per share were authorized; however, no preferred stock had been issued at December 31, 1995.

As a result of a proposed plan of exchange/reorganization, approved by the stockholders on April 19, 1990, the Company became a wholly owned subsidiary of The National Security Group, Inc. Also, pursuant to the reorganization, the Company's subsidiary, National Security Fire & Casualty Company, was contributed to The National Security Group, Inc.

The Company's capital structure at December 31, 2004, consisted of common capital stock of \$1,500,000, gross paid in and contributed surplus of \$401,752, and unassigned funds of \$8,396,260. The Company's total capital and surplus was \$10,298,012.

MANAGEMENT AND CONTROL

Stockholder

The Company is a wholly owned subsidiary of The National Security Insurance Group, Inc., a Delaware corporation.

Board of Directors

The Company's By-Laws provide that its business and affairs will be managed by a Board of Directors comprised of not less than three nor more than seven directors.

The following directors were elected at the March 17, 2004 annual meeting of the Stockholders and were serving at December 31, 2004:

Director/Residence

Principal Occupation

William Lister Brunson, Jr.
Elba, Alabama

President, National Security
Insurance Company
CEO, The National Security
Group

Mickey Lane Murdock
Elba, Alabama

Sr. Vice President, National
Security Insurance Company

James Douglas Martin, Jr.
Elba, Alabama

Vice President, National Security
Insurance Company

Brian Richard McLeod
Elba, Alabama

Secretary, National Security
Insurance Company

Committees

The Company's By-Laws provide that the Board of Directors may designate from among its members one or more committees which shall have and may exercise all the authority of the board of directors except as set forth in the By-Laws. The only committee serving at December 31, 2004, was the Investment Committee, which was comprised of the following members:

William Lister Brunson, Jr.
Mickey Lane Murdock
Brian Richard McLeod

The Investment Committee did not retain minutes of its meetings as required by the ALA. CODE §10-2B-16.01(a)(1975), which states,

A corporation shall keep as permanent records minutes of all meetings of its shareholders and board of directors, a record of all actions taken by the shareholders or board of directors without a meeting, and a record of all actions taken by a committee of the board of directors in place of the board of directors on behalf of the corporation.

Officers

The By-Laws specify that the Company's officers shall be a Chairman of the Board of Directors, a President, such Vice Presidents as the Board of Directors may determine, a Secretary, a Treasurer and such other officers as the directors may choose. Officers are elected for one-year terms or until their successors are chosen. Any two or more offices may be held by the same person, except the offices of the President and Secretary.

The following officers were elected by the Board of Directors on March 17, 2004, and were serving at December 31, 2004:

<u>Officer</u>	<u>Title</u>
William Lister Brunson, Jr.	Chairman & President
Mickey Lane Murdock	Sr. Vice President & Treasurer
James Douglas Martin, Jr.	Vice President
Brian Richard McLeod	Secretary & Assistant Treasurer
Betty Brunson	Assistant Secretary

Management and Service Agreements

The following agreements between the Company and its affiliates were in effect during the examination period and at December 31, 2004:

Personnel Agreement

Effective January 1, 1982, the Company accepted all employees of its affiliate National Security Fire and Casualty Company (NSF&C) as employees of the Company. NSF&C in turn agreed to reimburse the Company for all expenses involved in the employment of personnel who operated NSF&C. The stated purpose of this agreement was to bring NSF&C employees under the benefit plans that the Company had established.

Agreement for the Allocation of General and Administrative Expenses

Effective January 1, 1982, the agreement provides for allocation of salaries, fringe benefits, employment taxes and other common expenses between the Company and National Security Fire & Casualty Company (NSF&C) on the basis of the ratio of gross written premiums. The agreement also provides that NSF&C will pay the Company rent for office space based on a formula tied to the Company's cost in the building and the number of NSF&C employees.

This agreement was amended June 1, 1994, to include NSF&C's wholly owned subsidiary Omega One Insurance Company (Omega), which was organized in 1992. Omega has never had employees of its own, but has been operated by NSF&C personnel.

Agreement for Claims Adjustment Services

Effective July 1, 1981, the Company agreed to provide and train claims adjustors for National Security Fire & Casualty Company (NSF&C) and to

adjust claims for NSF&C and to be reimbursed by NSF&C at industry rates on a monthly basis.

The Company did not comply with its agreement for claims adjustment services with NSF&C. The agreement provides for NSF&C to pay the Company monthly for the services provided. In 2004, the Company allowed NSF&C to delay payment for the adjustor service fees for up to 90 days.

Tax Allocation Agreement

The tax allocation agreement in effect at December 31, 2004, has been effective since January 1, 1994. It provides that state and federal income taxes will be allocated among the parties on the basis of the actual tax liability. The parties to the agreement include:

The National Security Group, Inc. (NSG, holding company)
National Security Insurance Company
National Security Fire and Casualty Company
Omega One Insurance Company
NATSCO, Inc.

The tax allocation agreement was amended on January 21, 2002, to clarify the arrangement regarding tax related settlements between the parties. Each affiliate's balance each year will be calculated on an individual company basis. NSG will make all federal income tax deposits. In the event that an individual company has a tax benefit that can be used to offset the taxable income of another affiliated company in the consolidated federal tax return, any tax savings generated by the tax benefit will be remitted by the Company utilizing the tax benefit to the affiliate that generated the tax benefit at the applicable federal tax rate utilized by the entity receiving the benefit.

Agreement for Service Fee In Conjunction With Future First Life Insurance Administration System

In an agreement dated October 1, 2003, The National Security Insurance Group (NSG) agreed to provide the Company all rights and privileges to use the Future First Life Insurance Administration system for administering any and all life and health contracts in force with the Company. In consideration for these services, the Company agreed to pay NSG a monthly service fee of \$15,000, which is reimbursement of all direct costs incurred by NSG, including debt service. The initial term of the agreement was one year, commencing

November 1, 2003 and ending October 31, 2004. The agreement is renewable for successive one year periods until either party elects to terminate the agreement. The agreement may be terminated at any time by mutual consent or by either party at the end of any term by giving the other notice at least 30 days prior to the expiration of any one year term.

The Company did not comply with the terms of its agreement with NSG relating to the Future First Life Insurance Administration System. The agreement stipulated that the Company was to pay NSG monthly fees of \$15,000 effective November 2003. The Company deferred payment to NSG for the services until December 2004, when it paid for the initial 14 months of the monthly fees in one lump sum payment. Further discussion of the Company's agreement for the use of NSG's Future First Life Insurance Administration System is included in this report under the caption "ACCOUNTS AND RECORDS - Improper Accounting Recognition in Years Prior to 2004."

Conflicts of Interest

The Company has adopted a policy that requires that any material interest of its directors or officers that conflict, or might conflict, with the interest of the Company be disclosed to its Board of Directors. In order to implement this policy, the Company requires that its officers and directors execute conflict of interest statements annually.

Conflict of interest statements were filed by all directors and officers for each year under examination with the following exception. Betty Brunson, Assistant Secretary, did not file a conflict of interest statement during 2003 or 2004. No material conflicts were disclosed.

CORPORATE RECORDS

The Company's Articles of Incorporation and By-Laws, as amended, were inspected during the course of the examination and appeared to provide for operation of the Company in accordance with usual corporate practices and applicable statutes and regulations.

Minutes of the meetings of the Stockholder and Board of Directors were reviewed for the period under examination. The minutes appeared to be

complete and to adequately document the actions of the respective governing bodies.

HOLDING COMPANY AND AFFILIATE MATTERS

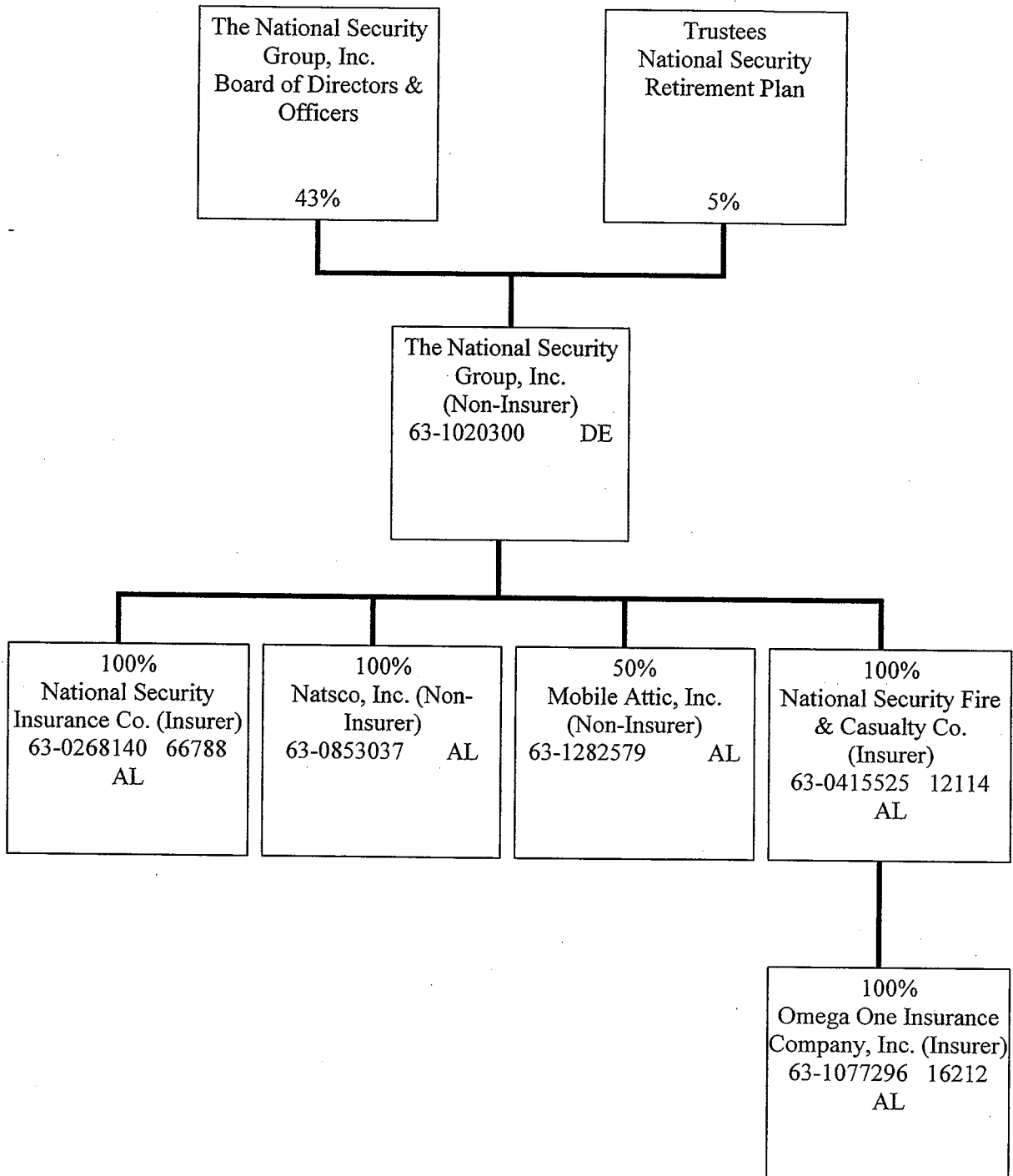
The Company is deemed to be subject to the Alabama Insurance Holding Company Regulatory Act of 1973, as defined in ALA. CODE §27-29-1 (1975), as amended. The Company is responsible for holding company registration and periodic informational filings with the Alabama Department of Insurance.

Holding company filings and amendments to registration statements made on behalf of the Company and its affiliates for the years under examination were reviewed. The filings and amendments were found to be substantially complete and to reflect the required disclosures.

Organizational Chart

The chart on the following page depicts the insurance holding company system with which the Company was affiliated as of December 31, 2004.

Organizational Chart



Dividends to Stockholders

During the period under examination the following cash dividends were paid to stockholders:

<u>Year</u>	<u>Dividends Paid</u>
2001	\$ 975,000
2002	\$1,000,000
2003	\$ 750,000
2004	\$ 800,000

The dividends paid were in accordance with Alabama statutes and regulations.

Dividends to Policyholders

During the period under examination the following policyholder dividends were paid to policyholders:

<u>Year</u>	<u>Dividends Paid</u>
2001	\$ 5,101
2002	\$11,522
2003	\$ 2,656
2004	\$ 4,512

FIDELITY BOND AND OTHER INSURANCE

The Company was insured by a Financial Institution Bond issued by Fidelity and Deposit Company of Baltimore, Maryland, at December 31, 2004. The bond provided dishonesty and fraud coverage for salaried officers, employees and persons with employment contracts. The bond did not provide coverage for forgery and alteration of securities. The Company's two insurer affiliates within the holding company system are also covered under the fidelity bond. The limit of coverage is to be applied to losses of all three in the aggregate. The limit of coverage of the fidelity bond did not meet the minimum amount suggested by the NAIC Financial Condition Examiners Handbook. The suggested minimum amount of fidelity bond coverage is from \$700,000 to \$800,000. The limit of coverage for the fidelity bond covering the Company and its two insurer affiliates is \$500,000.

In addition to the fidelity bond coverage, the Company was a named insured under policies providing the following protection at December 31, 2004:

- Commercial Property
- Electronic Data Processing Coverage
- Comprehensive Business Liability
- Comprehensive Automobile Fleet
- Comprehensive Business Umbrella Policy
- Boiler and Machinery
- Workers' Compensation
- Employment Liability
- Fiduciary Liability
- Directors' and Officers' Liability
- Outside Directorship Liability

The coverage and limits of the Company's insurance were reviewed and were deemed to adequately protect the Company's interest.

EMPLOYEE AND AGENT WELFARE

Benefits provided by the Company to its employees include the following at December 31, 2004:

- Group hospitalization plan
- Paid holidays
- Retirement 401(k)
- Medical benefits
- Funeral leave
- Life insurance
- Annual leave
- Sick leave

STATUTORY DEPOSITS

At December 31, 2004, as required or permitted by law, the Company maintained deposits with the respective statutory authorities as follows:

<u>State</u>	<u>Par Value</u>	<u>Statement Value</u>	<u>Market Value</u>
Alabama (1)	\$1,000,000	\$987,487	\$1,009,154
Georgia	\$50,000	\$0	\$50,346

(1) Held for the protection of all policyholders.

FINANCIAL CONDITION/GROWTH OF THE COMPANY

The following table sets forth the significant items indicating the growth and financial condition of the Company for the period under review:

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004*</u>
Admitted Assets	\$41,263,466	\$40,446,115	\$41,618,035	\$42,136,732
Liabilities	29,847,842	29,551,398	31,423,236	31,838,720
Common Capital Stock	1,500,000	1,500,000	1,500,000	1,500,000
Paid in and Contributed Surplus	401,752	401,752	401,752	401,752
Unassigned Funds	9,513,872	8,992,965	8,293,045	8,396,260
Gross Written Premium	5,205,906	5,441,250	5,843,163	6,200,125

*Per Exam

MARKET CONDUCT ACTIVITIES

Plan of Operation

As of December 31, 2004, the Company's agency force consisted of 17 home service agents and 1,385 independent agents. The agency forces are under the direction of three district managers and the overall supervision by a vice president of the Company. The home service agents and managers are paid salary plus commissions. The independent agents are paid commissions only. The Company's claims office was located at its home office in Elba, Alabama.

Territory

At December 31, 2004, the Company was licensed to transact business in the following states:

Alabama
Florida

Georgia
Mississippi

South Carolina
Texas

The certificates of authority from the respective jurisdictions were inspected and found to be in order.

Policy Forms and Underwriting

Policy Forms

Two new policy forms were filed during the examination period and both were properly approved by the Alabama Department of Insurance before the Company put them in use. There were no rate filings during the examination period.

Underwriting Practices

A review of relevant underwriting information was performed. This included reviewing the underwriting guidelines, declination procedures and cancellation procedures. The content of this information was reviewed for indications of unfairly discriminatory practices and to confirm that the Company underwriters and producers consistently apply the Company guidelines for all business selected and rejected.

Out of a population of 460, the examiner reviewed a sample of 50 declined applications to determine if the Company used reasons for rejection/declination that are not unfairly discriminatory and if the reasons for adverse underwriting decisions were provided to the applicant. Based upon the review, it was determined that the Company did not use reasons for rejection/declination that were unfairly discriminatory. It was noted during the review that each underwriting file in the sample contained a declination letter, and that in cases where the applicant was declined due to information obtained by the Medical Information Bureau the applicant was advised that he or she could receive such information upon request.

A sample of 100 company initiated cancellations was selected from the 22,831 policies cancelled during the examination period. The sample was reviewed to determine whether the reason for cancellation/non-renewal was valid according to policy provisions and state law and to determine if any unfairly

discriminatory practices used. The reason for cancellation for each item in the sample was either that it lapsed due to nonpayment of premium or that the insured requested cancellation. The reasons for cancellation were in accordance with the Company's policy provisions and were not unfairly discriminatory.

Advertising and Marketing

The Company did not have a formal advertising program, and did very little specific advertising of its insurance products. The Company had a limited number of advertisements appearing in insurance periodicals during the examination period. Brochures and advertising materials were distributed to potential customers through the Company's agents.

The Company did not comply with Alabama Insurance Department Regulation 69 §VII(1), which states,

Each insurer shall maintain at its home or principal office a complete file containing a specimen copy of every printed, published, or prepared advertisement of its individual policies and specimen copies of typical printed, published, or prepared advertisements of its blanket, franchise, and group policies, hereafter disseminated in this State, with a notation indicating the manner and extent of distribution and the form number of any policy advertised.

No indication or annotation was included in the advertising file indicating the extent of the distribution or the policy form number of the policy advertised when applicable. The information was not dated to indicate when the advertisements were distributed.

In relation to the replacement of customers' existing life insurance policies, the Company did not comply with Alabama Regulation No. 70 §7(C)(1), which states,

Where a replacement is involved: 1. Require from the agent with the application for life insurance a copy of the "Notice Regarding Replacement of Life Insurance" signed by the applicant, a copy of all Sales Proposals used for presentation to the applicant, and a list of all of the applicant's existing life insurance to be replaced. Such existing life insurance shall be identified by name or insurer and the policy number. In the event that a policy number has not been assigned by the existing

insurer, alternate identification information, such as an application or receipt number, must be listed...

The Company's replacement files did not include copies of all sales proposals and a list of all of the applicant's existing life insurance to be replaced.

Claims Review

The examiners reviewed samples of claims paid and denied and closed without payment claims that were processed during the examination period. The claims were reviewed to determine compliance with policy provisions, timeliness of payment and adequacy of documentation. The Company resisted payment only in cases where there appeared to be justifiable cause for further investigation and denial. There were no issues noted regarding the timeliness of payment.

Policyholder Complaints

The Company's complaint register indicated that 18 complaints were filed against the Company during the examination period. The complaints in the Company's complaint file were reviewed to determine whether the files included adequate documentation and whether the complaints were responded to properly and in a timely manner. No discrepancies were noted.

Compliance with Agents' Licensing Requirements

The Company had 1,385 licensed independent agents and 17 licensed home service agents as of December 31, 2004. There were 557 agencies that produced business for the Company during 2004.

The examiners made an inspection of the Company's records to determine if agents representing the Company in Alabama were properly licensed and appointed by the State of Alabama. The examiners compared the Company's 2004 listing of licensed and appointed agents to the Alabama Department of Insurance 2004 listing of agents appointed by the Company. The examiners also performed an examination involving the selection of a sample from new business issued in Alabama to determine whether the agents that produced the business were properly licensed and appointed. The examination indicated that

one of the Company's agents was not properly appointed as required by ALA. CODE §27-7-30(a)(1975), which states, "Each insurer appointing a producer in this state shall file with the commissioner...a notice of appointment..."

ALA. CODE §27-7-35.1(a)(1975) stipulates, "An insurance company or insurance producer shall not pay a commission, service fee, brokerage, or other valuable consideration to a person for selling, soliciting, or negotiating insurance in this state if that person is required to be licensed under this chapter and is not so licensed."

ALA. CODE §27-7-35.1(e)(1975) stipulates,

Any insurer or producer violating this section shall be liable for a fine in an amount of up to three times the amount of the commission paid. The fine shall be levied and collected by the commissioner. Upon failure to pay the fine the commissioner may, in his or her discretion, revoke the license of the producer or the insurer's certificate of authority, or both.

The examination indicated that the amount of commissions for new business paid to the agent during the period that the agent was not properly licensed and appointed summed to \$1,782. The amount of the fine that the Company is contingently liable for is \$5,348.

It was noted that the prior Report of Examination included a comment indicating that the Company was contingently liable for a fine in relation to commissions paid to unlicensed agents.

Privacy Standards

The Company does not share customers' private information with any nonaffiliated third parties except those permitted under Sections 14, 15, and 16 of ALA. ADMIN. CODE 482-1-122. The Company had adequate controls in place for employees that handled private information. As for the private information shared among the affiliated entities, the Company provided notices to its customers that indicated the types of information collected, the way it was used and the manner in which it was collected.

REINSURANCE

Reinsurance Assumed

The Company did not assume any reinsurance within the examination period.

Reinsurance Ceded

The Company had ceded reinsurance under reinsurance agreements with three reinsurers as of December 31, 2004. Total reserve credits taken in relation to the ceded business amounted to \$29,084, all of which was applicable to two reinsurance agreements with Swiss Re (formerly Life Re), Stamford, Connecticut, and Optimum Re, Dallas, Texas. The agreement with Swiss Re/Life Re was inactive and in run-off during the examination period. The Company also had business in force under a Servicemen's Group Life Insurance Pool reinsurance agreement with Prudential Insurance Company of America, Newark, New Jersey. This agreement was also inactive and in run-off during the examination period. The amount of business reinsured under this agreement was immaterial and no reserve credit was taken.

Reinsurance ceded by the Company during the examination period was ceded under two separate reinsurance treaties with Optimum Re Insurance Company (Optimum Re), Dallas, Texas. These two treaties are related as follows. Since January 13, 2000, Optimum Re has administered former American United Life (AUL) reinsurance business for the Company. Since that date, Optimum Re has provided reinsurance coverage for all new business.

Under the Optimum reinsurance agreement (formerly AUL agreement) the Company's retention for automatic reinsurance on any one life is \$50,000 for insureds under age 45, and \$25,000 for insureds age 45 and older. The reinsurer's limit is four times the Company's retention to a maximum of \$200,000 in excess of the Company's retention.

Under a second direct treaty with Optimum Re, only one plan of insurance is currently covered, Life 10. This plan provides for 50% quota share up to the retention identified above.

Insolvency agreements relative to all reinsurance agreements were found to be acceptable.

ACCOUNTS AND RECORDS

The Company's principal accounting records are maintained by computer with certain subsidiary records maintained manually. Generally, the Company's records were adequate to reflect the Company's transactions during the examination period and its financial condition at December 31, 2004.

Independent Auditor

The Company was audited for the years under examination by the certified public accounting firm of Barfield, Murphy, Shank & Smith, P.C., Birmingham, Alabama. It was noted that Jack Knight, CPA, was the person responsible for the 2004 independent auditor's report and that he had served in that capacity each year since 1992. Alabama Department of Insurance Regulation 482-1-100-.07(4)(a) states, "No partner or other person responsible for rendering a report may act in that capacity for more than seven (7) consecutive years..." The Company did not comply with the aforesaid regulation.

The audit reports and work papers of the independent auditor were reviewed by the examiners. The examiners did not utilize the work performed by the independent auditor.

The independent auditor did not include a review by a qualified actuary of the policy and contract claims reserves developed by the Company's consulting and opining actuary. The Company's consulting and opining actuary's work was relied upon. The examiners noted that the Company's consulting and opining actuary has been preparing an original work product that has not been subjected to review and/or testing by any independent, qualified third party with the exception of the periodic Alabama Department of Insurance statutory examinations.

As for utilizing a specialist that has a relationship with the client, the AICPA Professional Standards stipulates in Sections 336.10 and 336.11,

The auditor should evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity. Such circumstances include situations in which the client has

the ability---through employment, ownership, contractual right, family relationship, or otherwise---to directly or indirectly control or significantly influence the specialist. When a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. However, the work of a specialist who has a relationship with the client may be acceptable under certain circumstances. If the specialist has a relationship with the client, the auditor should assess the risk that the specialist's objectivity might be impaired. If the auditor believes the relationship might impair the specialist's objectivity, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should engage another specialist for that purpose.

The examiners determined that the Company's consulting actuary does have a relationship with the client through employment that may impair the actuary's objectivity. The CPA did not document the assessment of the risk of impaired objectivity or determine the necessity of performing additional procedures with respect to the actuary's assumptions, methods or findings.

The Company's independent CPAs relied upon the Company's consulting and opining actuary's reserve calculations instead of employing a qualified actuary to test the Company's reserves. According to the NAIC Annual Statement Instructions,

The insurer shall require the independent certified public accountant to subject the information included in the Supplemental Schedule of Assets and Liabilities to the auditing procedures applied to the audit of the current statutory financial statements to determine whether such information is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole and agrees to the insurer's annual statement filed with the state insurance departments and the NAIC.

Improper Accounting Recognition in Years Prior to 2004

The Company did not record and report a known liability of \$30,000 payable to The National Security Group (NSG) for two months of service fees (November and December of 2003) for the use of NSG's Future First Life Insurance Administration System. NSG agreed to provide the System to the Company for a fee of \$15,000 each month, due the first week of each month.

This agreement was effective November 2003. The Company settled the \$30,000 for November and December of 2003 in December 2004, when it paid for all of 2004. Further discussion of the Company's agreement for the use of NSG's Future First Life Insurance Administration System is included in this report under the caption "MANAGEMENT AND SERVICE AGREEMENTS - Agreement for Service Fee In Conjunction With Future First Life Insurance Administration System."

FINANCIAL STATEMENTS

The financial statements included in this report were prepared on the basis of the Company's records, and the valuations and determinations made during the examination for the year 2004. Amounts shown in the comparative statements for the years 2001, 2002 and 2003 were compiled from the Company's copies of the filed Annual Statements. The statements were presented in the following order:

Statement of Assets, Liabilities, Surplus and Other Funds	Pages 23 and 24
Summary of Operations	Page 25
Capital and Surplus Account	Page 26

National Security Insurance Company
Statement of Assets, Liabilities, Surplus and Other Funds
For the Year Ended December 31, 2004

Assets

	Assets	Non- Admitted Assets	Admitted Assets
Bonds <u>(Note 1)</u>	\$ 32,141,460	\$	\$ 32,141,460
Stocks (Common)	5,097,972		5,097,972
Mortgage loans on real estate	237,784		237,784
Properties occupied by the company	823,145		823,145
Properties held for sale	7,523		7,523
Cash and short-term investments <u>(Note 2)</u>	964,632		964,632
Contract loans	770,448		770,448
Other invested assets	3,550,000	3,550,000	
Investment income due and accrued	323,877		323,877
Deferred premiums, agents' balances and installments booked but deferred and not yet due	951,152	93,383	857,769
Current federal and foreign income tax recoverable and interest thereon	294,298		294,298
Electronic data processing equipment and software	409,675	139,041	270,634
Furniture and equipment, including health care delivery assets	347,555	347,555	
Receivables from parent, subsidiaries and affiliates	347,189		347,189
Other assets nonadmitted	2,673	2,673	
Aggregate write-ins for other than invested assets	28,154	28,154	
Total Assets	<u>\$ 46,297,537</u>	<u>\$ 4,160,805</u>	<u>\$ 42,136,732</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

National Security Insurance Company

Statement of Assets, Liabilities, Surplus and Other Funds

Liabilities, Surplus and Other Funds

Liabilities:

Aggregate reserve for all life contracts <u>(Note 3)</u>	\$ 25,882,252
Aggregate reserve for accident and health contracts <u>(Note 4)</u>	561,059
Liability for deposit-type contracts	1,306,460
Contract Claims-Life <u>(Note 5)</u>	275,370
Contract claims-Accident and health <u>(Note 5)</u>	144,310
Policyholders' dividends	5,100
Premiums and annuity considerations for life and accident and health contracts received in advance less discount; including accident and health premiums	41,199
Interest Maintenance Reserve	650,977
Commissions to agents due or accrued	15,159
General expenses due or accrued	482,013
Taxes, licenses and fees due or accrued, excluding federal income taxes	27,077
Net deferred tax liability	190,530
Unearned investment income	19,286
Amounts withheld or retained by company as agent or trustee	516
Amounts held for agents' accounts, including agents' credit balances	36,800
Remittances and items not allocated	108,598
Asset Valuation Reserve	1,152,840
Payable to parent, subsidiaries and affiliates	64,174
Drafts outstanding <u>(Note 2)</u>	0
Aggregate write-ins for liabilities <u>(Note 5)</u>	875,000
Total Liabilities	\$ 31,838,720

Capital and Surplus:

Common capital stock	\$ 1,500,000
Gross paid in and contributed surplus	401,752
Unassigned funds <u>(Note 6)</u>	8,396,260
Total Capital and Surplus	\$ 10,298,012
Total Liabilities and Stockholders' Equity	\$ 42,136,732

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

NATIONAL SECURITY INSURANCE COMPANY
SUMMARY OF OPERATIONS
For the Years Ended December 31, 2001, 2002, 2003, 2004

	2001	2002	2003	2004
Income:				
Premiums and annuity considerations for life and accident and health contracts	\$5,160,836	\$5,396,169	\$5,798,730	\$6,172,677
Net investment income	2,140,337	2,070,148	1,993,433	2,033,436
Amortization of Interest Maintenance reserve (IMR)	26,435	31,705	62,386	95,479
Aggregate write-ins for miscellaneous income	436,907	419,091	676,325	250,986
Total Income	<u>\$7,764,515</u>	<u>\$7,917,112</u>	<u>\$8,530,874</u>	<u>\$8,552,578</u>
Deductions:				
Death benefits	\$1,658,270	\$1,910,212	\$2,190,226	\$2,294,367
Matured endowments	18,806	19,035	9,519	100,524
Annuity benefits	9,269	4,109	320	
Disability benefits and benefits under accident and health contracts	403,247	337,253	474,145	412,704
Surrender benefits and withdrawals for life contracts	307,290	288,986	302,110	499,398
Interest and adjustments on contract or deposit type contract funds	71,781	72,346	71,983	36,981
Increase in aggregate reserves for life and accident and health contracts	539,051	444,546	592,145	593,811
TOTALS	<u>\$3,007,714</u>	<u>\$3,076,487</u>	<u>\$3,640,448</u>	<u>\$3,937,786</u>
Commissions on premiums, annuity considerations and deposit-type contract funds (direct business only)	\$1,885,673	\$2,193,880	\$2,318,302	\$2,004,698
General insurance expenses	2,153,605	1,908,122	2,369,983	2,468,483
Insurance taxes, licenses and fees, excluding federal income taxes	354,350	231,219	237,284	192,468
Increase in loading on deferred and uncollected premiums	152,160	(95,958)	51,801	17,249
Aggregate write-ins for deduction	200,000	40,000	200,000	75,000
TOTALS	<u>\$7,753,502</u>	<u>\$7,353,750</u>	<u>\$8,817,818</u>	<u>\$8,695,683</u>
Net gain from operations before dividends to policyholders and federal income taxes	\$ 11,012	\$ 563,362	\$ (286,944)	\$ (143,105)
Dividends to policyholders	5,586	11,522	2,656	(1,032)
Net gain from operations after dividends to policyholders and before federal income taxes	5,426	551,841	(289,600)	(142,073)
Federal and foreign income taxes incurred (excluding tax on capital gains)	(207,243)	45,776	(93,556)	(528,171)
Net gain from operations after dividends to policyholders and federal income taxes and before realized capital gains or (losses)	212,669	506,065	(196,044)	386,098
Net realized capital gains or (losses) less capital gains tax and transferred to the IMR	496,722	223,275	202,915	(94,137)
Net Income	<u>\$ 709,391</u>	<u>\$ 729,340</u>	<u>\$ 6,871</u>	<u>\$ 291,961</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

NATIONAL SECURITY INSURANCE COMPANY

CAPITAL AND SURPLUS

For the Years Ended December 31, 2001, 2002, 2003, 2004

	2001	2002	2003	2004
Capital and surplus, December 31, prior year	\$ 12,545,868	\$11,415,623	\$10,894,717	\$10,194,794
Net income	709,391	729,340	6,871	291,961
Change in net unrealized capital gains (losses)	(526,693)	(1,351,583)	553,971	517,424
Change in net deferred income tax	71,629	178,848	33,493	(61,430)
Change in nonadmitted assets and related items	(191,144)	(82,808)	55,601	127,861
Change in asset valuation reserve	194,639	1,005,297	(599,859)	27,401
Cumulative effect of changes in accounting principles	(413,067)			
Dividends to stockholders	(975,000)	(1,000,000)	(750,000)	(800,000)
Net change in capital and surplus for the year	(1,130,245)	(520,906)	(699,923)	103,217
Capital and surplus, December 31, current year	<u>\$ 11,415,623</u>	<u>\$ 10,894,717</u>	<u>\$ 10,194,794</u>	<u>\$ 10,298,011</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

NOTES TO FINANCIAL STATEMENTS

Note 1 – Bonds

\$32,141,460

The above captioned amount is the same as reported by the Company in its 2004 Annual Statement.

The examination indicated that a security that was assigned the NAIC designation “1” should have been assigned the NAIC designation of “1FE.” The Company’s accounting personnel assigned a designation of “1” if a security was rated by only one national security rating organization; the Company assigned a designation of “1FE” if the security was rated by two or more rating organizations; and the Company assigned a designation of “1” if the security was a governmental agency bond. This does not coincide with the instructions of Part Four Section 2(c)(i)(A) of the Purposes and Procedures Manual of the NAIC SVO, which state, “Bonds, that are: Rated and monitored by one NRSRO, will be assigned the equivalent NAIC Designation. If rated and monitored by more than one NRSRO, then the second highest rating will be assigned.” Assigned ratings are to be identified by the inclusion of “FE” with the assigned designation.

Note 2 – Cash and short-term investments

\$1,048,182

Drafts outstanding

\$ 0

The above captioned amount for “Cash and short-term investments” is \$41,775 more than that reported by the Company in its 2004 Annual Statement. The above captioned amount for “Drafts outstanding” is \$41,775 less than that reported by the Company in its 2004 Annual Statement.

The examination of the drafts outstanding detail indicated that the account was comprised of outstanding checks rather than outstanding drafts. Accounting personnel indicated that the outstanding checks were reclassified as drafts outstanding when the checks became stale dated. SSAP No. 2, paragraph 7, stipulates, “Outstanding checks are accounted for as a reduction of cash.”

The deposits that the Company combined in its 2004 Schedule E were inaccurately identified as being a deposit of one depository. The NAIC Annual Statement Instructions indicate that reporting entities are required to report in Schedule E “...separately all deposits in excess of \$100,000 or less than (\$100,000). Deposits not exceeding \$100,000 or not less than (\$100,000) in

federally insured depositories may be combined.” Deposits that are combined in Schedule E must be identified as a combination of deposits.

The Company reported an incorrect description for the special deposit for Georgia in Schedule E - Part 3 - Special Deposits of its 2004 Annual Statement.

Note 3 - Aggregate reserve for life contracts

\$25,882,252

The above captioned amount is the same as that reported by the Company in its 2004 Annual Statement.

There were six issues in relation to the Aggregate reserve for life contracts.

Issue 1

The examination actuary discovered errors in the calculation of the reserves for the industrial life policies and requested that the opining actuary recalculate those reserves as of December 31, 2004. During the course of that recalculation, the opining actuary discovered that the reserves for the graded death benefit policy were being calculated incorrectly. The opining actuary corrected a unit problem and recalculated those reserves and determined that the reserves should be increased by \$72,454. The examination actuary agreed with the revised reserves. The reported aggregate reserve for life contracts was understated by \$72,454 in relation to this examination finding. Due to the understatement being immaterial, no changes were made to the financial statements included in this report.

Issue 2

The reserves for certain supplemental benefits (substandard premium extra, guaranteed insurability and payor) were not being calculated or recorded correctly. The examination actuary determined the amount of the reserve understatement for the guaranteed insurability riders and the payor riders was \$2,163 and the amount of the reserve understatement for the substandard extra premium was \$9,014. The Aggregate reserve for life contracts was understated by \$11,177. Due to the understatement being immaterial, no changes were made to the financial statements included in this report.

Issue 3

The examination indicated that there were no reserves held and included in the Aggregate reserve for life contracts reported in the Company's 2004 Annual Statement for accidental death benefits and waiver of premium riders for its Central Life business life contracts. The omission resulted in the policy reserves being understated by \$4,860. The premium deficiency reserves in relation to the aforesaid policies were also omitted. The premium deficiency reserves for the omitted policies totaled \$6,012. The omissions resulted in an understatement of the aggregate reserve of \$10,872. The understatement is not material. Due to immateriality, no change is reflected in the financial statements for this item.

Issue 4

The Company did not retain a reconciliation and could not produce a reconciliation of its year ending 2004 reserve file to the number of policies and the amount of insurance in force reported in its 2004 Exhibit of Life Insurance. Variances of 898 policies and \$241,000 amount of insurance in-force at year-end were noted for 2004 when the examiners attempted to reconcile the Company's reserve valuation file to the Exhibit of Life Insurance.

Issue 5

The Company did not properly make the required disclosures in its 2004 Notes to Financial Statements.

- The Company did not make the required disclosure describing the consideration of the return of premium for periods beyond the date of death in its aggregate reserve for life contracts.
- The disclosure for the deficiency reserves is worded incorrectly. It should state "net premiums exceed gross premiums" rather than "gross premiums exceed net premiums." The disclosure also states that the deficiency reserves are \$0, whereas Exhibit 5 shows that the deficiency reserves amount to \$155,831.
- The disclosure for the analysis of increase in reserves is incorrect. It refers only to tabular interest as calculated by the required formula. The

disclosure must also address tabular less actual reserves released and tabular cost.

Issue 6

The examination noted that the Company's documentation regarding plan codes, plan benefits and reserve basis descriptions was poor. It was very difficult to cross reference from plan code to plan benefits to reserve basis description.

<u>Note 4 – Aggregate reserve for accident and health contracts</u>	<u>\$561,059</u>
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The above captioned amount is the same as reported by the Company in its 2004 Annual Statement.

The examination indicated that the Company was not recording proper reserves on some policies that were guaranteed renewal with level premiums that involved increasing morbidity costs. Such policies require that an active life reserve be recorded. The understatement of the "Aggregate reserve for accident and health contracts" due to the Company not recording the guaranteed renewable active life reserves was \$152,942. The understatement is not material. Due to immateriality, no change was made in the financial statements.

The examination indicated that no reserve was held at year end 2004 or reported in the Company's 2004 Annual Statement for accident and health contracts for its Central Life accident and health segment of its business. The omission resulted in the aggregate reserve being understated by \$18,047. The understatement is not material. Due to immateriality, no change was made in the financial statements.

<u>Note 5 - Contract Claims: Life</u>	<u>\$275,370</u>
<u>Contract Claims: Accident and health</u>	<u>\$144,310</u>
<u>Aggregate write-ins for liabilities</u>	<u>\$875,000</u>

The above captioned amounts are the same as the respective amounts reported by the Company in its 2004 Annual Statement.

There are three issues discussed below. The first identified as "Issue 1" relates to misclassified balances involving the three captioned line items. The second

identified as "Issue 2" relates only to "Contract claims: Life." The third issue identified as "Issue 3" relates only to "Contract claims: Accident and Health."

Issue 1

The "Aggregate write-ins for liabilities" reported in the 2004 Annual Statement included two reserves totaling \$50,000 for resisted and litigated life policy claims and one reserve of \$25,000 for a resisted and litigated accident and health claim. These reserves were determined to be misclassified. The reserves should have been reported in the contract claims liability on the line for the claim's respective line of business (life or accident and health) in accordance with SSAP No. 55, paragraph 6, of which, pertinent sections state, in part,

The following future costs relating to life and accident and health indemnity contracts, as defined in SSAP No. 50, shall be considered in determining the liability for unpaid claims and claim adjustment expenses: ...Claim liabilities for Life/Accident and Health Contracts: ...Resisted Claims in Course of Settlement: Liability for claims that are in dispute and are unresolved on the statement date...Claim Adjustment Expenses for Life Reporting Entities: Costs expected to be incurred (including legal and investigation) in connection with the adjustment and recording of life claims defined in subparagraph 6b.

There were no changes made to the financial statements included in this report due to the misclassification having no effect on the Company's surplus.

Furthermore, the two resisted life insurance claims should have been reported in the Company's 2004 Schedule F.

Issue 2

The Company did not record a claim adjustment expense for the cost of paying life insurance claim liabilities. The Company is required to record a reserve for future claim adjustment expenses by SSAP No. 55, paragraph 6, which states,

The following future costs relating to life and accident and health indemnity contracts, as defined in SSAP No. 50, shall be considered in determining the liability of unpaid claims and claims adjustment expenses: ...Claim Adjustment Expenses for Life Reporting Entities: Costs expected to be incurred (including legal and investigation) in

connection with the adjustment and recording of life claims defined in subparagraph 6 b.

The examination actuary determined that the amount that should be recorded for life insurance claim adjustment expenses was \$5,502, which is two per cent of the December 31, 2004, reported life claims liability. The understatement is not material. Due to immateriality, no change was made to the financial statements included in this report.

Issue 3

The Company did not record a claim adjustment expense for the cost of paying accident and health insurance claim liabilities. The Company is required to record a reserve for future claim adjustment expenses by SSAP No. 55, paragraph 6, which states,

The following future costs relating to life and accident and health indemnity contracts, as defined in SSAP No. 50, shall be considered in determining the liability of unpaid claims and claims adjustment expenses: ...Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims...

The examination actuary determined that the amount that should be recorded for accident and health insurance claims adjustment expenses was \$5,772, which is four per cent of the December 31, 2004, reported accident and health claims liability. The understatement is not material. Due to immateriality, no change was made to the financial statements included in this report.

Note 6 – Unassigned Funds

\$8,396,260

The above captioned amount is the same as reported by the Company in its 2004 Annual Statement. The following is a reconciliation of unassigned funds per the examination:

Unassigned funds per Company		\$8,396,260
Examination increase/(decrease) to assets:		
Cash and short-term investments	\$ (41,775)	
Examination (increase)/decrease to liabilities:		
Drafts outstanding	<u>41,775</u>	
Total adjustment to surplus	\$ 0	\$ <u>0</u>
Total Unassigned Funds Per Examination		\$8,396,260

COMMENTS AND RECOMMENDATIONS

Committees – Page 5

It is recommended that the Company keep minutes of its Investment Committee meetings as required by ALA. CODE §10-2B-16.01(a)(1975), which states,

A corporation shall keep as permanent records minutes of all meetings of its shareholders and board of directors, a record of all actions taken by the shareholders or board of directors without a meeting, and a record of all actions taken by a committee of the board of directors in place of the board of directors on behalf of the corporation.

Management and Service Agreements – Page 6

It is recommended that the Company comply with the terms of its agreement for claims adjustment services with National Security Fire & Casualty Company (NSF&C) and require NSF&C to pay the Company monthly for the services provided.

It is recommended that the Company comply with the terms of its agreement with The National Security Group (NSG) relating to the Future First Life Insurance Administration System, particularly the requirement to pay NSG monthly.

Conflicts of Interest – Page 8

It is recommended that the Company require each of its officers and directors to file conflict of interest statements each year in order to ensure that the Company complies with the Annual Statement General Interrogatory requirement of disclosing all conflicts of interest.

Fidelity Bond and Other Insurance – Page 11

It is recommended that the company maintain fidelity bond coverage of an amount that is at least as much as the minimum amount suggested by the NAIC Financial Condition Examiners Handbook.

Advertising and Marketing – Page 15

It is recommended that the company maintain a record of all advertisements in accordance with Alabama Insurance Department Regulation 69 §VII(1), which states,

Each insurer shall maintain at its home or principal office a complete file containing a specimen copy of every printed, published, or prepared advertisement of its individual policies and specimen copies of typical printed, published, or prepared advertisements of its blanket, franchise, and group policies, hereafter disseminated in this State, with a notation indicating the manner and extent of distribution and the form number of any policy advertised.

It is recommended that the Company include in its policy replacement files all documentation required by Alabama Regulation No. 70 §7(C)(1), which states,

Where a replacement is involved: 1. Require from the agent with the application for life insurance a copy of the "Notice Regarding Replacement of Life Insurance" signed by the applicant, a copy of all Sales Proposals used for presentation to the applicant, and a list of all of the applicant's existing life insurance to be replaced. Such existing life insurance shall be identified by name or insurer and the policy number. In the event that a policy number has not been assigned by the existing insurer, alternate identification information, such as an application or receipt number, must be listed.

Compliance with Agents Licensing Requirements – Page 16

It is recommended that the Company ensure that all of its agents are properly licensed and not pay commissions to agents that are not licensed in accordance with ALA. CODE §27-7-35.1(a)(1975), which stipulates, "An insurance company or insurance producer shall not pay a commission, service fee, brokerage, or other valuable consideration to a person for selling, soliciting, or

negotiating insurance in this state if that person is required to be licensed under this chapter and is not so licensed.”

Accounts and Records – Page 19

It is recommended that the Company employ a different CPA than the one that has been responsible for the independent auditor’s report for each year from 1992 to 2004 to remedy the Company’s failure to comply with Alabama Department of Insurance Regulation 482-1-100-.07(4)(a), which states, “No partner or other person responsible for rendering a report may act in that capacity for more than seven (7) consecutive years...”

It is recommended that the Company require its CPA to evaluate the Company’s relationship with the consulting and opining actuary to determine whether the actuary’s work is to be relied upon for the independent audit as required by AICPA Professional Standards Sections 336.10 and 336.11, which state,

The auditor should evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist’s objectivity. Such circumstances include situations in which the client has the ability---through employment, ownership, contractual right, family relationship, or otherwise---to directly or indirectly control or significantly influence the specialist. When a specialist does not have a relationship with the client, the specialist’s work usually will provide the auditor with greater assurance of reliability. However, the work of a specialist who has a relationship with the client may be acceptable under certain circumstances. If the specialist has a relationship with the client, the auditor should assess the risk that the specialist’s objectivity might be impaired. If the auditor believes the relationship might impair the specialist’s objectivity, the auditor should perform additional procedures with respect to some or all of the specialist’s assumptions, methods, or findings to determine that the findings are not unreasonable or should engage another specialist for that purpose.

It is recommended that the Company require its CPA to employ a qualified actuary in the auditing process to ascertain that the life and accident and health reserves are fairly stated in all material respects in accordance with the NAIC Annual Statement Instructions, which state,

The insurer shall require the independent certified public accountant to subject the information included in the Supplemental Schedule of Assets and Liabilities to the auditing procedures applied to the audit of the current statutory financial statements to determine whether such information is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole and agrees to the insurer's annual statement filed with the state insurance departments and the NAIC.

It is recommended that the Company properly record in its ledger and report in its financial statements all known liabilities.

Bonds – Page 27

It is recommended that the Company properly identify all securities it assigns ratings and does not file with the NAIC Securities Valuation Office with the "FE" designation.

Cash and short-term investments and Drafts Outstanding – Page 27

It is recommended that the Company account for all outstanding checks as a reduction of cash in accordance with SSAP No. 2, paragraph 7, which stipulates, "Outstanding checks are accounted for as a reduction of cash."

It is recommended that the Company accurately identify its balances in open depositories in the Annual Statement Schedule E - Part 1.

It is recommended that the Company accurately report the description of all securities reported in Schedule E - Part 3.

Aggregate reserve for life contracts and Aggregate write-ins for liabilities – Page 28

It is recommended that the Company implement practices and procedures to ascertain the inclusion, and the accurate calculation thereof, of the reserves for all life contract benefits in its "Aggregate reserve for life contracts."

It is recommended that the Company retain a reconciliation at each year end of its year ending reserve file to the number of policies and the amount of insurance in force reported in the Annual Statement Exhibit of Life Insurance.

It is recommended that the Company make the required disclosures relative to the "Aggregate reserve for life contracts" as described in SSAP No. 51, paragraphs 37 and 38.

It is recommended that the Company improve its documentation relating to its plan codes, plan benefits and reserve basis descriptions. Similar recommendations were made as a result of the examinations of the Company as of December 31, 1995, and December 31, 2000.

Aggregate reserve for accident and health contracts – Page 30

It is recommended that the Company implement practices and procedures to ascertain the inclusion, and the accurate calculation thereof, of the reserves for all accident and health contracts that require reserves in its "Aggregate reserve for accident and health contracts."

Contract claims: Life; Accident and health and Aggregate write-ins for liabilities – Page 30

It is recommended that the Company report all resisted and litigated claims in the applicable line items "Contract claims: Life" or "Contract claims: Accident and health" consistent with SSAP No. 55, paragraph 6, of which, pertinent sections state,

The following future costs relating to life and accident and health indemnity contracts, as defined in SSAP No. 50, shall be considered in determining the liability for unpaid claims and claim adjustment expenses: ...Claim liabilities for Life/Accident and Health Contracts: ...Resisted Claims in Course of Settlement: Liability for claims that are in dispute and are unresolved on the statement date...Claim Adjustment Expenses for Life Reporting Entities: Costs expected to be incurred (including legal and investigation) in connection with the adjustment and recording of life claims defined in subparagraph 6b.

It is recommended that the Company include all resisted and litigated claims in its Annual Statement Schedule F.

It is recommended that the Company explicitly record claim adjustment expense liabilities for life and accident and health insurance claims in accordance with SSAP No. 55, paragraph 6, which states,

The following future costs relating to life and accident and health indemnity contracts, as defined in SSAP No. 50, shall be considered in determining the liability of unpaid claims and claims adjustment expenses: ... Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims... Claim Adjustment Expenses for Life Reporting Entities: Costs expected to be incurred (including legal and investigation) in connection with the adjustment and recording of life claims defined in subparagraph 6 b...

Compliance With Previous Recommendations – Page 39

It is recommended that the Company comply with the Report of Examination recommendations.

CONTINGENT LIABILITIES AND PENDING LITIGATION

The examination of contingencies and pending litigation included the review of the Company's Annual Statement disclosures, holding company documents and agreements with affiliates, minutes of the corporate governing bodies, pending claims, attorney letters obtained by the examiners and those obtained by the independent auditor and the usual examination of the accounts for unrecorded items. No material contingencies or pending litigation against the Company were identified, other than those reported in the 2004 Annual Statement.

A contingency reported in the 2004 Annual Statement that was deemed to be outside of the ordinary course of business involved pending litigation in relation to the past sale of industrial burial insurance and whether the premium charged was discriminatory relative to the race of the insured.

A stipulated settlement agreement was provided to the examiners in relation to the class action race based premium litigation. The Company has stipulated to an agreement with the plaintiffs' attorneys. The stipulated agreement will be presented in a hearing on May 11, 2006, to determine whether the proposed settlement and the terms and conditions of the stipulated settlement are fair, reasonable and adequate and whether the court will approve the settlement. The review of the settlement terms indicated that the Company's current unpaid liabilities in relation to the settlement are estimated to be \$2,971,466.

The Company held a reserve for the settlement costs including all payments to plaintiffs and legal and actuarial fees of \$800,000 at December 31, 2004.

The review of correspondence and preliminary settlement documents and discussions with Company officials indicated that it was Company management's desire to obtain a permitted practice from the Commissioner to deviate from statutory accounting principles. The proposed permitted practice would involve the Company utilizing a phase in period to perform periodic graduated increases of the required statutory reserves in relation to policy face amounts that are to be increased in accordance with the preliminary settlement. The discussion indicated that the proposed phase in period would be for approximately three years. The Alabama Department of Insurance has not consented to a permitted practice at this time.

Management represented that the Company uses a 3% factor in calculating its policy reserves for certain burial policies, which results in conservatively stated reserves because ALA. CODE §27-17-16 allows for the policies to be calculated using a factor of between 1% and 6%. Management indicated that they believe that the Company can use a 4½% factor for the burial policy reserves and the result will be reasonably conservative reserves and the resulting gain in surplus from the reduction in the burial policy reserves will be adequate to offset the decrease in surplus that will result when the settlement of the race based premium litigation is fully recognized.

Further discussion of the class action race based premium litigation is included in this report under the caption "SUBSEQUENT EVENTS."

COMPLIANCE WITH PREVIOUS RECOMMENDATIONS

A review was performed to determine if the Company had complied with the recommendations made in the last examination report. The review indicated that the Company had complied with the recommendations contained in the immediately preceding Report of Examination with the exception of the items listed below.

The previous Report of Recommendation recommended that the Company improve its documentation relating to its plan codes and plan benefits and reserve basis descriptions. The examination indicated that the Company has not improved its documentation with regard to its plan codes, plan benefits and reserve basis descriptions.

The previous Report of Examination indicated that the Company paid commissions to agents that were not properly licensed. The current examination indicated that the Company has paid commissions to an agent that was not properly licensed.

SUBSEQUENT EVENTS

The review of events subsequent to December 31, 2004 did not reveal anything material in amount or noteworthy in nature, except the ongoing race based premium litigation.

Company management indicated that the Company had stipulated to an agreement to settle its pending class action race based premium litigation. The proposed settlement that the Company has agreed to indicates that the Company's current unpaid liabilities in relation to the proposed settlement is estimated to be \$2,971,466. The Company held a reserve as of March 7, 2006 of \$1,030,000 for the pending litigation. Further discussion of the class action race based premium litigation is included in this report under the caption "CONTINGENT LIABILITIES AND PENDING LITIGATION."

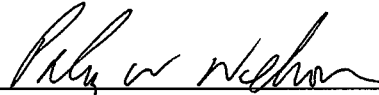
CONCLUSION

Acknowledgement is hereby made of the courtesy and cooperation extended by all persons representing National Security Insurance Company during this examination.

The customary insurance examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed in connection with the verification and valuation of assets and the determination of liabilities set forth in this report.

In addition to the undersigned, Toni Bean, Angie Block, Douglas Brown, Laura Chapman, Bobby McKinnon, Felicia McKinzy, Alfonzo Nunn and Thomas Salo, Examiners; and Harland Dyer, ASA, MAAA, Consulting Actuary; all representing the Alabama Department of Insurance, participated in this examination of National Security Insurance Company.

Respectfully submitted,



Palmer W. Nelson, CFE
Examiner-in-charge
Alabama Department of Insurance
Southeastern Zone, NAIC